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Skadden

Inside the Courts
An Update From Skadden Securities Litigators

Books and Records

Court of Chancery Orders Production of Emails, Denies Production of Privileged Communications in Books and Records Action

Emps.' Ret. Sys. of R.I. v. Facebook, Inc., C.A. No. 2020-0085-JRS (Del. Ch. Feb. 10, 2021)
Click here to view the opinion.

In a post-trial opinion, Vice Chancellor Joseph R. Slights III granted a stockholder's request to inspect directors' nonprivileged electronic communications, including emails, concerning settlement negotiations for the purpose of investigating whether Facebook overpaid in the settlement to protect its CEO, Mark Zuckerberg, from substantial personal liability.

In July 2019, in connection with a data breach, Facebook agreed to pay $5 billion to the Federal Trade Commission (FTC) in exchange for the release of claims against the company and Mr. Zuckerberg personally. Facebook stockholder Employees' Retirement System of Rhode Island (ERSRI) sought books and records to investigate whether Facebook spent corporate assets to protect Mr. Zuckerberg. Facebook produced some documents but refused to produce (i) electronic communications concerning the FTC negotiations and (ii) privileged documents (including electronic communications and unredacted copies of board and committee minutes) concerning the FTC negotiations. Facebook objected to producing these documents on two grounds. First, Facebook argued that the documents were not "necessary and essential" to ERSRI's stated purpose for inspection. Second, Facebook claimed that inspection of certain of the documents was barred under attorney-client privilege and work product immunity.

With respect to the nonprivileged electronic communications, the court held that the documents were necessary and essential to evaluate the board's process in reaching the settlement and to determine the degree to which the board intentionally caused Facebook to pay more in order to shield Mr. Zuckerberg from personal liability. The court rejected Facebook's argument that ERSRI already possessed sufficient documents to assess the board's deliberative process for the settlement. The court acknowledged that Facebook's outside counsel sent a document to the FTC outlining its view that Facebook's maximum exposure fell well below the $5 billion it ultimately agreed to pay, and it was a matter of public record that Mr. Zuckerberg's personal liability was a central focus of the negotiations between Facebook and the FTC. But the traditional board materials already produced were "bereft" of any nonprivileged information regarding why Facebook would "pay more than its (apparently) maximum exposure to settle a claim" or would have "conditioned any settlement with the FTC on the FTC's agreement to release Zuckerberg from liability." The court ordered Facebook to produce these documents and stated that ERSRI "is right to question whether internal communications among Facebook fiduciaries might shed light" on the board's decision-making process.

For the privileged communications, the court found that ERSRI could not meet the heavy burden of demonstrating "good cause" under *Garner* to overcome Facebook's assertion of privilege. Specifically, ERSRI admitted that it could not demonstrate that the privileged information it sought was unavailable elsewhere because the nonprivileged communications it had yet to receive might satisfy its purpose.

Definition of a Security

Eastern District of Louisiana Holds That Loan and Security Agreement Can Constitute a Security but Rejects Plaintiff Investors' Allegations of Securities Fraud

Callais Cap. Mgmt., LLC v. Wilhite, No. 17-12039, 2021 WL 1216526 (E.D. La. Mar. 31, 2021)
Click here to view the opinion.

The court granted a motion to dismiss a plaintiff investor's claims of securities fraud against a digital sports media company for alleged violations of Section 10(b) of the Securities and Exchange Act, SEC Rule 10b-5 thereunder and other state and common law causes of action.

The plaintiff in this case, Callais Capital Management (CCM), brought claims against Sqor, a digital media company focused on sports, Sqor's directors and management, and employees of Sqor's investment bank. Prior to commencing the lawsuit, CCM engaged in four transactions with Sqor based on a loan and security agreement (LSA) and three supplements to the agreement that gave CCM the right to purchase shares of preferred stock from Sqor. In all, CCM invested more than $16 million in Sqor.

The first of CCM's claims revolved around the business plan the defendants presented to CCM before CCM made its initial investment. CCM alleged that the business plan contained false representations that Sqor could fund immediate growth, secure up to 10 major sports enterprises over the next six months and raise a round of equity capital totaling $25 million, among other statements. CCM alleged that these figures were false and that various defendants knew that Sqor did not have the amount of fans, users or social reach that the business plan claimed it had. CCM also alleged that the defendants' brand capabilities deck contained various misrepresentations, including that it portrayed a celebrity athlete's social media followers as Sqor's user base, that certain celebrity athletes would drive a certain volume of ad impressions and that it had endorsements that it did not in fact receive.

CCM further alleged that the defendants misrepresented both the likelihood that Sqor would enter into business initiatives or agreements with sports organizations and how close its negotiations were to cumulating in profitable deals. CCM alleged that the defendants reiterated all of the above misrepresentations during in-person meetings, telephone conferences and through written correspondence. Sqor filed for bankruptcy in 2017, two years after the LSA had been negotiated.

In their motion to dismiss, the defendants argued that, as a threshold matter, CCM could not base its securities claims on the LSA and its supplements because they were not securities. Specifically, the defendants argued that the LSA and supplements did not constitute notes under *Reves v. Ernst & Young*, 494 U.S. 56 (1990), or investment contracts under *SEC v. W.J. Howey Co*., 328 U.S. 293 (1946). The defendants further argued that CCM failed to properly plead each essential element of a securities fraud claim under the Private Securities Litigation Reform Act's (PSLRA) heightened standards and Federal Rule of Civil Procedure 9(b), specifically because CCM failed to plead actionable misrepresentations or omissions, reasonable reliance or loss causation, and that CCM's state law claims failed for the same reasons. The defendants also argued that CCM did not plead adequate facts to establish control person liability.

The court ultimately agreed with the defendants. However, as a threshold matter, the court ruled that the LSA and its supplements were indeed notes and therefore were considered securities for purposes of the federal securities laws. The court applied the test established by the U.S. Supreme Court in *Reves*, which presumes a note to be a security unless it closely resembles a "family" of instruments that are not considered to be securities. The court concluded that the instruments at issue were not sufficiently similar to any of the established "families" of nonsecurities, and so they had to be evaluated under the four factors articulated in *Reves*, which include (i) the motivations that would prompt a reasonable seller and buyer to enter into the transactions at issue, (ii) the "plan of distribution" of the instrument, (iii) the reasonable expectations of the investing public, and (iv) the existence of another regulatory scheme that would reduce the risk of the instrument.

The court found that, when considered together, the *Reves* factors supported the conclusion that the LSA and its supplements were notes and therefore securities. Because the court found the instruments were notes, it did not address whether the instruments were investment contracts under *SEC v. W.J. Howey Co.* The court also found that CCM was not barred or estopped from arguing that the LSA and its supplements were notes, even though CCM had previously characterized them as loans in bankruptcy proceedings. The court found that CCM's characterizations in the bankruptcy proceedings were not deliberate or clear enough to estop CCM from making the argument.

In turning to the substance of the securities law claims, the court found that the CCM's complaint failed to adequately state a claim for securities fraud. Examining the business plan and the brand capabilities deck, the court held that CCM failed to plead specific facts tying specific corporate officers to the statements at issue in the business plan and brand capabilities deck. The court further found CCM's allegations employed impermissible group pleading in failing to allege which statements were attributable to which defendant. The court also held that certain forward-looking statements in the business plan fell within the PSLRA's safe harbor because CCM failed to allege that the statements were made or approved with actual knowledge of their falsity or misleading nature. The court also held that the allegations regarding other statements failed to satisfy the particularity requirements of the PSLRA and Rule 9(b).

Given these findings, the court did not reach the defendant's arguments regarding scienter, reasonable reliance, loss causation or control person liability. The court also declined to exercise supplemental jurisdiction over CCM's remaining state law claims because it had already eliminated CCM's federal claims. The court accordingly granted the defendant's motion to dismiss and denied the plaintiff leave to amend the complaint.

On April 23, 2021, CCM filed a notice of appeal of the court's decision to the Fifth Circuit. The appeal is pending.

Extraterritoriality

Northern District of Florida Dismisses Securities Fraud Lawsuit Alleging Misrepresentations in Connection With Sale of Securities on Over-the-Counter Market

Acerra v. Trulieve Cannabis Corp., No. 4:20cv186-RH-MJF (N.D. Fla. Mar. 18, 2021)
Click here to view the opinion.

The court dismissed a securities fraud lawsuit alleging misrepresentations in connection with the sale of securities on a Canadian stock exchange and a U.S.-based over-the-counter financial market, holding that the U.S. securities laws did not apply to the transactions at issue.

Trulieve is a vertically integrated medical marijuana company traded on a Canadian stock exchange and OTCQX, a U.S.-based over-the-counter financial market for securities. The plaintiffs, purported Trulieve shareholders, asserted claims under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 thereunder, alleging that Trulieve had (i) falsely claimed in Canadian public filings that it used greenhouse-style facilities to grow marijuana and (ii) failed to properly disclose related-party transactions.

Applying the U.S. Supreme Court's decision in *Morrison v. National Australia Bank Ltd*., 561 U.S. 247 (2010), which held that the anti-fraud provisions of the U.S. securities laws regulate only "transactions in securities listed on domestic exchanges" and "domestic transactions in other securities," the court dismissed the complaint. The court first rejected the plaintiffs' argument that their transactions in Trulieve securities were subject to the federal securities laws because Trulieve is traded on the U.S.-based OTCQX over-the-counter market. The court noted that the Securities and Exchange Commission (SEC) has used its authority under 15 U.S.C. § 78mm to exempt over-the-counter markets from the Securities Exchange Act's definition of domestic exchanges and concluded that because the only other place Trulieve's securities are traded is a Canadian stock exchange, the securities transactions at issue were not "transactions in securities listed on" a domestic exchange.

The court then rejected the plaintiffs' argument that their suit involved "domestic transactions in other securities." The court rejected the plaintiffs' theory that Trulieve could be liable under the Securities Exchange Act because it sells marijuana in the United States and the alleged misstatements and related-party transactions occurred in Florida. The court held that because the plaintiffs had not alleged that they took title to Trulieve's securities or became obligated to buy them in the United States, they had not pled sufficient facts to invoke the Securities Exchange Act.

Fiduciary Duties

Court of Chancery Sustains Stockholder Challenges to Merger

In re CBS Corp. S'holder Class Action & Derivative Litig., Consol. C.A. No. 2020-0111-JRS (Del. Ch. Jan. 27, 2021, corrected Feb. 4, 2021)
Click here to view the opinion.

Vice Chancellor Joseph R. Slights III sustained breach of fiduciary duty claims by stockholders of CBS Corporation against CBS directors and its controlling stockholders following CBS' merger with Viacom, Inc. in December 2019.

The complaint alleged that in 2016, CBS' controlling stockholder, Shari E. Redstone, who indirectly holds a controlling interest in both CBS and Viacom Inc. through her indirect ownership in National Amusements, Inc. (NAI), began to pursue a merger of CBS and Viacom. The merger was initially rejected by an independent special committee of the CBS board of directors. In early 2018, Ms. Redstone again proposed that CBS and Viacom merge, and the independent members of the CBS board of directors planned to approve a stock dividend to dilute NAI's voting power from 80% to 17%. They then sought a temporary restraining order in the Court of Chancery prohibiting Ms. Redstone from interfering with the composition of the CBS board, the stock dividend or any other decisions taken by the CBS board at the special meeting. According to the plaintiffs, litigation "abruptly settled" in September 2018. As part of the settlement, the parties agreed to various corporate changes, and Ms. Redstone agreed to be prohibited from proposing for a period of two years "directly or indirectly" that CBS merge with Viacom, "unless at least two-thirds (2/3) of the CBS directors not affiliated with NAI proposed one or asked for a proposal."

The plaintiffs alleged that months later, however, Ms. Redstone began raising to the CBS board members the idea of a third merger attempt. In the process, she attended CBS board committee meetings, including meetings where members discussed and approved increases to the salary of CBS' president and acting CEO, Joseph Ianniello. On August 13, 2019, CBS and Viacom announced the merger, which closed on December 4, 2019.

After obtaining documents pursuant to 8 Del. C. § 220, three CBS stockholders filed separate actions asserting claims for breach of fiduciary duty, waste and unjust enrichment, challenging the merger and other acts by members of the board, including a decision to increase Mr. Ianniello's salary. After the complaints were consolidated, the defendants filed motions to dismiss, which the court largely denied.

The court held that the plaintiffs adequately pled that Ms. Redstone and NAI had engaged in a conflicted transaction and conceivably breached their fiduciary duties as controlling stockholders. The court also held that the plaintiffs had well pled "demand futility because a majority of the members of the CBS Board that would have considered a demand face a substantial likelihood of liability for the non-exculpated breach of their fiduciary duty of loyalty in negotiating the Merger and facilitating Ms. Redstone's quid pro quo with Ianniello [regarding his salary increase]." With respect to Mr. Ianniello's merger-related compensation package, the court held that "Plaintiffs have well pled that the then-extant CBS Board and Ianniello breached their fiduciary duties by approving and accepting, respectively, the compensation for the purpose of furthering the controller's interests to the detriment of CBS and its minority stockholders."

Inside the Courts
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D&O Liability Coverage

Delaware Supreme Court Holds Fraudulent Conduct Is Insurable

RSUI Indem. Co. v. Murdock, No. 154, 2020 (Del. Mar. 3, 2021)
Click here to view the opinion.

The Delaware Supreme Court affirmed the Delaware Superior Court's determination that liability arising from the fraudulent conduct of directors and officers is insurable under Delaware law, and providing such coverage does not run afoul of Delaware public policy.

The disputed coverage resulted from the settlement of two lawsuits: a breach of fiduciary duty action in the Delaware Court of Chancery and a federal securities class action in the U.S. District Court for the District of Delaware. In 2015, the Court of Chancery ruled that David Murdock, CEO and a director of Dole Food Company, Inc., had both "breached his duty of loyalty by orchestrating an unfair, self-interested transaction" and "engaged in fraud." The parties settled for the full amount of damages awarded by the Court of Chancery. Relying on the court's breach of loyalty and fraud findings, a different group of stockholders sought damages for violations of the Securities Exchange Act in the federal district court. Those parties agreed to a settlement.

RSUI Indemnity Company insured Dole through an excess directors and officers (D&O) coverage policy. RSUI sought a declaratory judgment in Superior Court that it had no obligation under the policy to fund the settlements. After a series of opinions resolving pretrial motions, the Superior Court ultimately entered judgment in favor of Dole and against RSUI in the amount of the policy limits plus prejudgment interest.

On appeal, the Delaware Supreme Court first analyzed a potentially case-dispositive choice-of-law issue. Recognizing the absence of a choice-of-law provision in the policy, the court applied the *Second Restatement*'s "most significant relationship" test. The court observed that Dole is incorporated in Delaware, the policy's subject matter is D&O liability and Delaware has specific statutorily expressed policies affecting D&O liability. Further, because Delaware law typically governs the duties of the officers and directors of a Delaware corporation, corporations must consider Delaware law when determining their need for D&O coverage.

The court next rejected RSUI's argument that to the extent the policy provides coverage for losses predicated on fraud, it is unenforceable as contrary to Delaware public policy. The court reaffirmed the right of sophisticated parties to engage in private ordering. The policy included a broad definition of "covered losses" that did not facially exclude losses occasioned by fraud. The court found that Delaware public policy, as expressed by statute, favors insurability of losses incurred from a breach of duty of loyalty — including breaches surrounded by fraud.

Defensive Measures

Court of Chancery Enjoins Stockholder Rights Plan Adopted During Pandemic

The Williams Cos. S'holder Litig., C.A. No. 2020-0707-KSJM (Del. Ch. Feb. 26, 2021)
Click here to view the opinion.

Vice Chancellor Kathaleen S. McCormick permanently enjoined the continued operation of a stockholder rights plan that was adopted during the COVID-19 pandemic in response to general concerns about stockholder activism.

On March 19, 2020, the board of directors of The Williams Companies adopted a one-year stockholder rights plan in response to the severe decline of Williams' stock price resulting from plummeting oil prices and the COVID-19 pandemic, and concerns about opportunistic activist stockholders acquiring a substantial position in the company. The plan included a 5% trigger, an expansive definition of "beneficial ownership" and of "acting in concert," and a narrow definition of "passive investor."

Stockholders of Williams sued to permanently enjoin the plan, alleging that it was unenforceable and adopted in breach of the Williams directors' fiduciary duties under *Unocal*. As a threshold matter, the court held that the stockholders' challenge to the plan was direct, rather than derivative, noting that the plan's particular combination of features "infringe[d] on the stockholders' ability to communicate freely in connection with the stockholder franchise," a harm that "flow[ed] to stockholders and not the Company." As a result, the plaintiffs' claims were not subject to a higher pleading standard under Court of Chancery Rule 23.1.

The court also rejected the defendants' arguments that the board's adoption of the plan should be evaluated under the business judgment rule rather than under *Unocal*, because there is no "omnipresent specter" of entrenchment where a rights plan is designed to address stockholder activism as opposed to hostile takeover attempts. The court explained that under controlling Delaware Supreme Court authority, "all poison[] pills, 'by … nature,' have a potentially entrenching 'effect,'" and *Unocal* therefore applies.

The court evaluated the plan as a defensive measure under *Unocal*, which requires directors to prove reasonable grounds to perceive a threat to the corporation and its stockholders, and that the defensive measure is reasonable in proportion to the threat, not preclusive or draconian. The court held that the board conducted a good faith, reasonable investigation when adopting the plan. However, the court held that the general desire to prevent stockholder activism during a time of market uncertainty and low stock price did not present a cognizable threat under *Unocal*. The court also explained that "[r]easonable minds can dispute whether short-termism or distraction [caused by activism] could be deemed cognizable threats under Delaware law," but for Williams, the threat was purely hypothetical.

The court then assumed, without deciding, that a concern that activists might rapidly accumulate over 5% of the company's stock (a so-called "lightning strike attack") could constitute a cognizable threat under *Unocal*. The court determined that the plan did not fall within a range of reasonable responses to that purported threat. It emphasized the unusual nature of the 5% trigger, noting that of the precedent rights plans identified by Williams' banker, only 2% had triggers below 10%. The court further noted that the plan was one of only nine rights plans to ever use a 5% trigger outside the context of preserving net operating losses. The court was also critical of the "acting in concert" provision as being overly broad and vague, with a potential "chilling effect" on stockholder communications. In addition, the court described a "daisy chain" concept included in the plan that would trigger the plan if "stockholders act in concert with one another by separately and independently 'Acting in Concert' with the same third party" — which "operates to aggregate stockholders even if members of the group have no idea that the other stockholders exist." Ultimately, the court concluded that the plan did not fall within a range of reasonable responses to the purported threat and enjoined its operation.

Mergers and Acquisitions

Court of Chancery Grants in Part, Denies in Part Motion To Dismiss Claims Arising Out of Sale of Controlled Company to Third Party

Firefighters' Pension Sys. v. Presidio, Inc., C.A. No. 2019-0839-JTL (Del. Ch. Jan. 29, 2021)
Click here to view the opinion.

Vice Chancellor J. Travis Laster dismissed claims against directors of Presidio, Inc. and Presidio's controlling stockholder arising out of the sale of Presidio to a private equity buyer (the Buyer), while sustaining claims against Presidio's chairman/CEO, the Buyer and Presidio's financial advisor.

The Buyer acquired Presidio in December 2019. Approximately seven months prior, in May 2019, Presidio's controlling stockholder began exploring a sale of the company, assisted by financial advisor LionTree Advisors, LLC. The controller and LionTree held early exploratory meetings with the Buyer, a potential financial buyer, and Clayton Dubilier & Rice, LLC (CD&R), a potential strategic buyer. In June 2019, LionTree and Presidio's chairman/CEO met with CD&R about a possible transaction with Presidio. CD&R allegedly suggested to the chairman/CEO that it desired a merger of equals with a portfolio company, in which his continued employment would not be guaranteed. According to the plaintiffs, neither LionTree nor the chairman/CEO disclosed the meeting with CD&R to Presidio's board until several weeks later. The plaintiffs further alleged that when the meeting was disclosed, LionTree downplayed it as "a casual discussion of the landscape" and told the board that CD&R had been "in no rush to consider strategic options."

In early July 2019, the Buyer contacted LionTree to discuss a potential acquisition of Presidio. The plaintiffs alleged that at a July 8 meeting during which Presidio's board considered whether to engage with the Buyer and/or solicit interest from CD&R, LionTree told Presidio's board that CD&R conveyed it was "focused on closing [a] pending acquisition" and was "not focused on a strategic transaction in the near term." According to the plaintiffs, in fact, CD&R's "pending" acquisition had already closed, and CD&R had expressed interest to LionTree in pursuing a transaction with Presidio. The plaintiffs alleged that based on LionTree's advice, which the chairman/CEO did not contradict, the board directed LionTree to engage with the Buyer and elected not to contact CD&R.

Presidio entered into an agreement with the Buyer to purchase Presidio for $16 per share in cash. During a subsequent go-shop, CD&R submitted a topping bid for $16.50 per share. Presidio notified the Buyer the following day that CD&R was an "[e]xcluded [p]arty" as defined in the merger agreement. However, the plaintiffs alleged that nearly two hours before that official notice was sent, LionTree tipped off the Buyer to CD&R's offer and, inferably, informed the Buyer of its price. Later that evening, the Buyer submitted a revised offer to LionTree at $16.60 per share — it contained a 24-hour deadline and provided for an amended merger agreement (AMA) that would strip CD&R of a discounted termination fee. Presidio's board directed LionTree to tell CD&R that it had until 5 p.m. the following day to submit a revised offer. Despite that deadline, CD&R again topped the Buyer's bid with a nonbinding indication of interest at $17 per share but rejected the increased termination fee and threatened to walk away if Presidio signed the AMA. Presidio signed the AMA, and CD&R disengaged.

Post-closing, the plaintiff, a former Presidio stockholder, sued Presidio's controlling stockholder for breach of fiduciary duty or, in the alternative, aiding and abetting breaches of fiduciary duty;

the members of the Presidio board for breaches of fiduciary duty; Presidio's chairman/CEO for breaches of fiduciary duty in his capacities as both a director and an officer; the Buyer for aiding and abetting; and LionTree for aiding and abetting breaches of fiduciary duty.

The court first examined the applicable standard of review. It rejected arguments that the controller was "conflicted" because of an alleged need for liquidity and acknowledged that the controller received the same consideration as all other stockholders. The court then found that *Corwin* was inapplicable because, even though the controller was not conflicted, the stockholder vote was not fully informed, because the merger proxy was materially misleading. Among other things, the court held that the complaint adequately alleged that "LionTree tipped [the Buyer] about the details of CD&R's bid, including the price," and "[t]he Proxy made no mention of LionTree's tip to [the Buyer]."

The court also found that *In re Synthes Inc*. was inapplicable. Under *Synthes*, the business judgment rule applies to transactions, notwithstanding the presence of a controlling shareholder, so long as they do not involve self-dealing and any controlling stockholder receives the same consideration as the minority holders. However, the court held that "[t]he *Synthes* decision stands in contrast with *McMullin v. Beran*, 765 A.2d 910 (Del. 2000), in which the Delaware Supreme Court applied enhanced scrutiny to the sale of a company by a controlling stockholder in which all of the company's stockholders received the same per-share consideration in cash," and in which the Supreme Court applied the intermediate standard of enhanced scrutiny under *Revlon*.

Applying enhanced scrutiny, the court found that it was reasonable to infer that the Presidio board breached its duty of care in failing to provide "active and direct oversight" of LionTree. Although these constituted exculpated violations of the duty of care, and the court therefore dismissed the fiduciary duty claims against the directors (other than the chairman/CEO), these breaches of the duty of care were sufficient to satisfy the underlying breach element of the aiding and abetting claims against LionTree and the Buyer.

The court sustained the fiduciary duty claims against the chairman/CEO as both a director and an officer, finding it was "reasonably conceivable that [he] tilted the sale process in favor of [the Buyer] and steered the Board away from a deal with CD&R for self-interested reasons." However, the court dismissed the fiduciary duty claims against the controller in its capacity as controlling stockholder, concluding that there were insufficient pled facts to support an inference of gross negligence.

Materiality

Northern District of Illinois Denies Motion To Dismiss in Securities Fraud Putative Class Action

Lowry v. RTI Surgical Holdings, Inc., No. 20 C 1939 (N.D. Ill. Apr. 1, 2021)
Click here to view the opinion.

Judge Matthew F. Kennelly denied a motion to dismiss a putative class action against RTI Surgical Holdings and a number of its current and former officers, holding that the plaintiff satisfied the PSLRA and Rule 9(b) pleading standards. The plaintiff alleges that RTI engaged in improper revenue smoothing from March 2016 to March 2020 by shipping goods to customers early in order to meet quarterly revenue targets. Consequently, the plaintiff claims, RTI's financial statements and reports were false, in violation of Sections 10(b) and 20(a) of the Securities Exchange Act. After performing an internal audit — precipitated by an SEC investigation into RTI's accounting from 2014 to 2016 — RTI announced that it would restate five years of financial statements. Following the announcement, RTI's share price dropped, losing one fourth of its value.

The plaintiff's allegations are based in part on statements by four confidential witnesses. A former director of corporate accounts at RTI stated that executives directed employees to ask customers to accept shipments early, and that he was instructed to ship an order early when a customer refused. Similar descriptions of RTI's practices and the officer defendants' involvement were provided by two former RTI employees who worked directly with the officer defendants. A former employee of an RTI customer stated that RTI shipped products to the customer early without obtaining permission.

As a result of these practices, the plaintiff contends, RTI's communications regarding its financial performance were materially false and misleading. In March 2020, RTI announced that it could not file SEC Form 10-K because it was undergoing an internal audit of its revenue recognition practices triggered by an SEC investigation of its practices from 2014 to 2016. One month later, RTI disclosed that it had to restate its financial statements for the years 2014 through 2019. These disclosures were followed by share price declines.

The defendants moved to dismiss, arguing that the plaintiff failed to adequately allege that RTI's alleged misrepresentations were material or made with scienter. The court did not find the defendants' arguments persuasive. Under generally accepted accounting principles, previously reported financial statements should only be restated to correct material errors. RTI's need to restate these statements therefore weighed in favor of materiality. The market's swift reaction to RTI's corrective disclosures likewise persuaded the judge that RTI's alleged misstatements were material.

The court held that the confidential witness statements, the individual defendants' roles in maintaining internal controls coupled with their later admission that these controls were defective and the "nature and extent" of RTI's misrepresentations raised a "strong inference" of scienter. The defendants argued that the plaintiff was required to allege the defendants' motive in order to raise an inference of scienter. The court clarified that there was no legal basis for this argument, and the plaintiff need only plead facts indicating the defendants' intent to deceive or reckless disregard for the truth. For these reasons, the court held that the plaintiff stated a claim upon which relief could be granted.

Securities Fraud Pleading Standards

Misrepresentations

Ninth Circuit Holds That Section 14(a) Claims Are Subject to *Omnicare* Standard for Challenging Opinion Statements

Golub v. Gigamon, Inc., No. 19-16975 (9th Cir. Apr. 20, 2021)
Click here to view the opinion.

The Ninth Circuit held that the U.S. Supreme Court's opinion in *Omnicare, Inc. v. Laborers' District Council Construction Industry Pension Fund*, 575 U.S. 175 (2015), which set forth the pleading standard for a plaintiff challenging allegedly false or misleading opinion statements in a registration statement pursuant to Section 11 of the Securities Act, applies to claims alleging false or misleading statements in a proxy solicitation pursuant to Section 14(a) of the Securities Exchange Act.

Gigamon filed a proxy statement with the SEC urging its shareholders to vote in favor of a proposed transaction to sell the company. The plaintiff, a purported Gigamon shareholder, filed a putative class action under Section 14(a) of the Securities Exchange Act and SEC Rule 14a-9 thereunder, alleging that the company's directors and officers had conspired to sell Gigamon at an undervalued price and made false or misleading statements in the proxy to persuade shareholders to approve the transaction. The district court dismissed the complaint for failure to allege false or misleading statements that could overcome the safe harbor provision in the PSLRA for forward-looking statements accompanied by meaningful cautionary language.

On appeal, the Ninth Circuit affirmed. In a published opinion, the court held that because Section 14(a)'s language prohibiting false or misleading statements in connection with proxy solicitations is materially similar to the language in Section 11 of the Securities Act that the U.S. Supreme Court considered in *Omnicare*, the *Omnicare* standard applies when a plaintiff challenges opinion statements under Section 14(a).

In a concurrently filed unpublished opinion, the court applied *Omnicare* and affirmed the district court's dismissal of the complaint. The court first rejected the plaintiff's challenge to the board's statements in the proxy that the transaction was in the company's best interest, holding that the plaintiff failed to plead facts showing that the directors did not actually hold this opinion, particularly since the company had just come off two consecutive disappointing quarters.

The court next rejected the plaintiff's argument that the board's opinion statements contained embedded false statements of fact, holding that any embedded factual assertions were forward-looking statements about the company's future financial prospects protected by the PSLRA's safe harbor provision.

Finally, the court held that the plaintiff could not allege an omissions-based fraud theory based on the company's failure to include positive partial results for the quarter during which the proxy was released, because companies generally only release financial results at the end of the quarter, and one partial quarter of positive results was not enough to show that the board did not believe the sale was in the company's best interest after two previous disappointing quarters.

Second Circuit Affirms in Part and Reverses in Part Dismissal of Claims Against Consumer Finance Company

In re Synchrony Fin. Sec. Litig., No. 20-1352 (2d Cir. Feb. 16, 2021)
Click here to view the opinion.

The Second Circuit affirmed in part and reversed in part the judgment of the district court dismissing claims brought under Sections 10(b) and 20(a) of the Securities Exchange Act and Sections 11 and 15 of the Securities Act by a putative class of investors against a consumer finance company that provides private label credit cards affiliated with specific retailers, as well as several of its officers and other financial institutions involved in the company's December 1, 2017, note offering. The plaintiffs alleged that the defendants materially misrepresented the company's changes in underwriting standards that had alienated some of its retail partners and caused both the company's annual net income and its stock price to decline.

The plaintiffs alleged that the company's statement that it was "not getting any pushback" from its retail partners as a result of the company's tightened underwriting practices as to subprime borrowers was knowingly false when made because one of the company's key retail partners had responded to the company's changed underwriting practices by soliciting bids from other credit card issuers by late 2017. The Second Circuit held that the statement was actionable because the company's general disclosure about the competitive nature of the consumer finance market did not cure the company's allegedly misleading statement that it had not received any negative feedback from its retail partners regarding its underwriting changes by January 2018.

The Second Circuit, however, affirmed the district court's dismissal of the plaintiffs' claims arising from statements that the company was "pretty confident" and "pretty positive" about the prospect of renewing its retail partnerships in 2019 and that its underwriting standards were "stable" and "consistent[]" because they were nonactionable forward-looking statements, nonactionable statements of corporate optimism or otherwise nonactionable because they did not alter the total mix of publicly disclosed information. The Second Circuit also affirmed the dismissal of the plaintiffs' Securities Act claims pertaining to statements made by the company in its note offering materials conveying the company's generally optimistic view of its relationship with its retail partners because the statements were too vague and generic to "invite reasonable reliance."

Northern District of Illinois Dismisses Securities Class Action, Holding That Plaintiffs Did Not Plead Claim With Specificity

Macovski v. Groupon, Inc., No. 1:20-cv-02581
(N.D. Ill. Apr. 28, 2021)
Click here to view the opinion.

Judge Matthew F. Kennelly granted a motion to dismiss a putative securities class action against Groupon, Inc. and its executives. The plaintiffs filed a claim under the Securities Exchange Act, alleging that the defendants misled investors by omitting material adverse information relating to Groupon's "Select" program and the company's performance in a subcategory of its sales called "Goods." The defendants filed a motion to dismiss for failure to state a claim. The court dismissed the complaint, holding that the plaintiffs did not plead their claim with the specificity required under the PSLRA.

At issue are two of Groupon's sales categories, "Local" and "Goods." "Local" consists of local services and activities sold by Groupon, but performed by a third party. "Goods" consists of merchandise sold directly to customers. "Local" was Groupon's primary profit driver, making up 40% of the company's consolidated revenue and 70% of the company's gross profits. "Goods" made up 55% of the company's consolidated revenue but only 20% of gross profits. Groupon executives asserted that the company saw value in "Goods" as an engagement driver. The company believed that "Goods" drew customers to other, higher profit-margin areas of the site. "Goods" was especially important to Groupon, as the company was experiencing challenges in both drawing users to the site and keeping active customers.

In an effort to boost purchases, Groupon introduced its "Select" program in late 2018. The program charged a monthly fee in exchange for discounted products and other benefits. Throughout the class period, the defendants asserted that "Select" was performing well, improving purchase frequency and average order value, with the caveat that the program was still in its early days.

In February 2020, Groupon announced that it was exiting the "Goods" category and was not allowing further enrollment in its "Select" program. The company asserted that these decisions were related. "Goods" was no longer generating enough engagement with other areas of the site to justify further investment, and "Select" mostly appealed to customers purchasing "Goods." The day after the announcement, Groupon's share price dropped from $3.05 to $1.70. The plaintiffs filed suit following that drop.

Under the PSLRA pleading requirements, a complaint must specify each statement alleged to have been misleading and the reasons why the statements are misleading. Here, the plaintiffs inserted long block quotes and argued that they met the pleading standard because they put the alleged misleading representations in bold. The court disagreed, noting that some of the bolded statements were obviously benign or made by outside analysts, and could not be misleading representations. The court added that the complaint never specifically identified which representations were misleading. Thus the court held that the plaintiffs failed to adequately plead their claim and granted the defendants' motion to dismiss.

District of Minnesota Denies Motion To Dismiss Securities Class Action Following Spin-Off

In re Resideo Techs., Inc., Sec. Litig., No. 19-cv-2863
(D. Minn. Mar. 30, 2021)
Click here to view the opinion.

Judge Wilhelmina M. Wright denied a motion to dismiss securities claims in a putative class action against Resideo Technologies and its executives. The allegations arose from the October 2018 spinoff of Resideo from Honeywell International. According to the plaintiffs, Honeywell spun off Resideo to offload failing business lines and billions of dollars' worth of liabilities.

In 2017, Honeywell announced plans to spin off product lines from various divisions into a new entity called Resideo. In an October, 10, 2018, SEC disclosure, Resideo projected its 2019 revenue to be $500 million. On October 29, 2018, Resideo became an independent, publicly traded company and commenced trading at $28 per share. In March 2019, Resideo lowered its projected revenue for 2019 from $500 million to between $410 million and $430 million. In October 2019, Resideo further dropped its revenue projection to a range of $330-$350 million. On November 6, 2019, Resideo disclosed several factors that contributed to its failure to meet revenue projections. On that day, Resideo's share price closed at $10.02. The plaintiffs alleged that Resideo was aware of the factors contributing to its underperformance at the time of the spinoff or otherwise made false statements prior to the disclosure.

The plaintiffs brought a putative class action alleging the defendants made false statements or material omissions in violation of Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 thereunder. The defendants moved to dismiss, arguing that the plaintiffs failed to meet the heightened pleading standards of the PSLRA, which require plaintiffs to identify the defendants' materially misleading statements, explain why they were misleading and plead facts raising an inference of scienter.

The defendants argued that the plaintiffs failed to plead material misrepresentations because Resideo's forward-looking statements were accompanied by cautionary language, placing the statements within the protections of the PSLRA's safe harbor. The plaintiffs countered that the defendants knew of existing supply chain and production issues at the time, when they stated that those issues might become a future problem. The safe harbor does not apply when a forward-looking statement was made with knowledge that it was false or misleading. The court held that the plaintiffs' allegations, taken as true, demonstrate that any cautionary language did not insulate defendants from their actual knowledge of existing problems.

The defendants further argued that the plaintiffs alleged "fraud by hindsight" by relying on statements made after the relevant period to support their claims. A complaint impermissibly pleads fraud by hindsight when it alleges a defendant's statement was false based on subsequently available information without also alleging that the defendant knew the statement was false at the time it was made. The court found no merit in this argument because the plaintiffs supported their allegations with confidential witness testimony that Resideo's executives knew statements were false or misleading at the time they were made.

The defendants attempted to rebut a finding of scienter by offering an alternative, nonculpable explanation that Resideo's underperformance was caused by Honeywell setting unrealistic expectations, supply chain problems and other market conditions. The defendants contended that they disclosed risks and deficiencies as soon as management discovered them. The plaintiffs offered evidence that the defendants failed to disclose facts they knew and instead encouraged employees to avoid using email to discuss damaging information in order to avoid discovery. The plaintiffs also argued that the immediacy with which a new chief financial officer discovered the issues after taking over the role demonstrated the defendants' recklessness. The court found the plaintiffs' allegations created cogent and sufficiently compelling inferences of scienter because the common features of the former Honeywell units comprising Resideo were their liabilities rather than business similarities, the defendants failed adequately to explain their alleged recklessness or efforts to conceal damaging information, and Honeywell's stock rose significantly during the relevant period while Resideo's dramatically declined. Having found that the plaintiffs met the heightened pleading standards for material misrepresentations and scienter, the court denied the motion to dismiss.

SDNY Dismisses Securities Exchange Act Claims Against Network and Technology Company for Failure To Plead Falsity

In re Nokia Corp. Sec. Litig., No. 1:19-cv-03982 (ALC) (S.D.N.Y. Mar. 29, 2021)
Click here to view the opinion.

Judge Andrew L. Carter Jr. dismissed claims brought by a putative class of investors against a Finnish network and technology company and its former CEO alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act. The plaintiff alleged that the company misled investors about the post-acquisition integration with a different telecommunications company and the company's readiness for its upcoming transition to 5G technology. The plaintiffs alleged that the company failed to disclose certain ongoing risks associated with the integration that impacted the company's readiness to transition to 5G, including past compliance issues with the integrated company.

The court determined that the plaintiffs failed to identify any false or misleading statements, and that the company's statements concerning the success of its integration with the telecommunications company were not false or misleading because the plaintiffs failed to identify any integration targets that were said to have been met that had not actually occurred. The complaint's vague references to "integration" and "significant problems" were insufficient to plead falsity. The company's disclosure of past compliance issues also did not render all statements regarding integration false. And the company adequately warned investors about the risks and uncertainties regarding a successful integration.

The court also determined that the statements regarding the company's 5G transition were not false or misleading because the company disclosed the challenges it was having with its transition to 5G technology in relation to the integration and the status of its 5G progress. The court reasoned that a majority of the statements were also protected under the PSLRA's safe harbor because they clearly forward-looking statements and were accompanied by robust disclosures.

District of Massachusetts Dismisses Complaint Against Consumer Robot Company

In re iRobot Corp. Sec. Litig., No. 19-cv-12536-DJC (D. Mass. Mar. 12, 2021)
Click here to view the opinion.

Judge Denise J. Casper dismissed claims brought by a putative class of investors against a consumer robot company alleging that it violated Sections 10(b) and 20(a) of the Securities Exchange Act by making false and misleading statements about increased competition and trade tariffs imposed on the import of Chinese-manufactured products. The plaintiffs alleged that the company downplayed the impact of increased competition on the company's revenue growth and failed to disclose adverse competitive trends showing a decline in consumer demand and sales, and that the imposition of trade tariffs by the U.S. government during the U.S.-China trade war exacerbated the company's reduced financial guidance.

The court held that the challenged statements concerning consumer demand, market share and sales were not adequately alleged to be false or misleading. Accurate historical statements about demand and market share were not rendered misleading by the alleged omission of adverse competitive trends. Allegations from a single confidential witness that the company's market share had declined by 10% in October 2018 was not supported by any particularized facts and in any event did not render misleading statements discussing iRobot's market share at the end of 2018 and the first half of 2019. The company disclosed before and during the class period that it was facing increased competitive pressure that could cause a loss of market share, and those disclosures were consistent with the generalized statements made by "confidential witnesses."

The court also determined that the complaint failed to adequately allege scienter. The court rejected the plaintiffs' allegations that the defendants knew or were reckless in not knowing that their statements were false because they concerned one of the company's core products. The court also rejected the plaintiffs' allegations that the resignations of certain company executives were suspiciously timed. The information the plaintiffs obtained from six confidential witnesses was insufficient because the witnesses were not in a position to know the information that was alleged or were otherwise unreliable. Finally, there were no allegations of insider trading, no allegations of any motive to commit fraud and no allegations identifying specific internal reports contradicting any of the challenged statements.

SDNY Dismisses Securities Act Claims Against Cannabis Company and an Underwriting Syndicate in Connection With Company's IPO

In re Hexo Corp. Sec. Litig., No. 19 Civ. 10965 (NRB) (S.D.N.Y. Mar. 8, 2021)
Click here to view the opinion.

Judge Naomi R. Buchwald dismissed claims brought by a putative class of investors against a cannabis company, several of its officers and directors, and an underwriting syndicate involved in the company's initial public offering (IPO) alleging violations of Sections 11, 12(a)(2) and 15 of the Securities Act and of Sections 10(b) and 20(a) of the Securities Exchange Act. The plaintiffs alleged that the company entered into a supply agreement with a Canadian government-run cannabis dispensary and that the supply agreement included a "take-or-pay" provision under which the dispensary agreed to either order or purchase a certain amount of the company's product in the first year following the Canadian legalization of adult-use recreational cannabis in 2018. When the dispensary failed to perform on the "take-or-pay" provision, the company decided to amend instead of enforce the supply agreement. The plaintiffs alleged that this failure to enforce the provision rendered misleading certain statements in the offering materials that represented the supply agreement as a guarantee. The plaintiffs further alleged that in other public disclosures, the company misled investors regarding its financial reporting and guidance and its acquisition of another cannabis company, as well as the capabilities of that company's facilities.

The court held that the offering materials were not false or misleading. The court noted that the plaintiffs' claims were based on hindsight because the plaintiffs did not allege that the defendants knew any information when they issued the offering materials upon which to conclude that the company would not enforce the "take-or-pay" provision against the dispensary. The court also held that the offering materials disclosed the relevant risks in accordance with Items 303 and 105 of the SEC Regulation S-K, and concluded that because the offering materials made clear to investors the risks of the investment, the alleged misstatements were protected by the bespeaks caution doctrine. The court additionally held that the plaintiffs lacked standing to bring Section 12(a)(2) claims because they did not purchase their shares directly in the IPO. Finally, the court dismissed the Securities Exchange Act claims because the plaintiffs failed to allege scienter, as they identified no "reports or statements containing adverse facts to which defendants had access at the time the statements at issue were made."

EDNY Dismisses Class Action Against Cannabis Company That Allegedly Concealed Regulatory Risks

In re Curaleaf Holdings, Inc. Sec. Litig., No. 19-cv-4486 (BMC) (E.D.N.Y. Feb. 16, 2021)
Click here to view the opinion.

Judge Brian M. Cogan dismissed with prejudice a securities class action brought under Sections 20(b) and 10(b) of the Securities Exchange Act against a cannabis company that alleged that a drop in the company's stock price was caused by improperly marketed cannabidiol (CBD) products. The plaintiffs alleged that the company failed to disclose that its CBD products were not approved by the Food and Drug Administration (FDA) and that the FDA might consider the sale of the products to be a violation of law. The plaintiffs alleged that this nondisclosure materially misled investors because the company had received a letter from the FDA warning that the company's sale of CBD products violated federal law.

The court dismissed the complaint because "starting on its first day in existence, the [c]ompany publicly and repeatedly acknowledged the very information that plaintiffs contend it concealed." The court found that the company had disclosed the potential risk with sufficient detail that a reasonable investor could not be misled about the risk, even if the company did not specifically discuss FDA guidance that stated that the sale of CBD products was illegal. The court held that the company need not include in every public statement a full list of risks and that additional disclosures in the company's press releases would not have altered "the 'total mix' of information available to a reasonable investor." Finally, the court determined that with respect to the company's statements about the health benefits of its CBD products, the plaintiffs failed to plead loss causation: The FDA letter did not opine on the safety and efficacy of the CBD products, and therefore the subsequent price drop could not be tied to the alleged misrepresentations regarding the health benefits.

District of Rhode Island Dismisses Complaint Against Health Care Company Concerning Its Struggling Long-Term Care Business

City of Miami Fire Fighters' and Police Officers' Ret. Tr. v. CVS Health Corp., No. 19-437-MSM-PAS (D.R.I. Feb. 11, 2021)
Click here to view the opinion.

Judge Mary S. McElroy dismissed claims brought by a putative class of investors against a national health care company and certain of its officers, alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act by making false and misleading statements in their financial reports regarding their long-term care (LTC) business following the acquisition of a pharmaceutical distributor company.

The court held that the challenged statements about the company's performance and the success of its operations were not actionable. Statements pointing to a "profitable picture" of the alliance between the company and the acquired pharmaceutical distributor were nonactionable statements of corporate "optimism" or "puffery" that no reasonable investor would rely on. Similarly, the court held that the challenged statement that the company was a "leader" was not actionable because the plaintiffs failed to plead particularized contradictory facts, such as a timeline of the defendant company's customer losses.

The court further determined that the defendants' statements referring, for example, to the "challenges" of "client retention rates" did not create a duty to disclose the extent of customer losses the company was sustaining because the statements were not specific and did not "state or even imply that the customer base was *growing*." Finally, the court determined that although the company's goodwill assessments attributed to its LTC business eventually took a "significant impairment," the complaint failed to plead that the initial goodwill assessments misleadingly failed to disclose the extent of the problems in the recently acquired LTC business. The court found that the complaint simply provided "retrospective disagreement" with the company's judgment and lacked contemporaneous facts to undermine the assumptions underlying the goodwill assessments.

SDNY Dismisses Complaint Against Global Logistics Company Concerning Impact of Cyberattack

In Re FedEx Corp. Sec. Litig., No. 1:19-cv-05990 (RA) (S.D.N.Y. Feb. 4, 2021)
Click here to view the opinion.

Judge Ronnie Abrams dismissed claims brought by a putative class of investors against a global logistics company and certain of its current and former officers, alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act by concealing the full financial impact of a June 2017 Russian cyberattack on the company's recently acquired European subsidiary.

The court held that the company's numerous disclosures during the class period about the impact of the Russian cyberattack on the company's operations and financials undermined the plaintiff's claim that investors were misled about the financial impact the cyberattack had on the company. The court reasoned that the challenged statements about income targets for one segment of the company's business were not adequately alleged to be false or misleading because the alleged omissions about issues with the European subsidiary's operations did not contradict the company's years-long income target for the entire business segment. The alleged difficulties with the subsidiary were not sufficient on their own to render the income target "unrealistic." The challenged income-target statements were also not actionable because they were forward-looking statements protected by the PSLRA's safe harbor and were accompanied by meaningful disclosures about the risks inherent with the integration of the European subsidiary.

The court also found that the challenged statements about the Russian cyberattack and restoration of the subsidiary's operations were not actionable because those statements were "tempered by disclosures" about the effect of the cyberattack on the company and the nature of an ongoing recovery effort. The court further determined that many of the challenged statements contained "carefully hedged language" that would not lead a reasonable investor to conclude that recovery efforts were complete. For example, the company referred to recovery efforts as "near-normal" and stated that "substantially all" operational systems had been restored. The court likewise rejected the plaintiff's argument that the company's statements about the European subsidiary's operations were misleading because it failed to disclose that the subsidiary lost 10% of its high-margin customers. The company repeatedly disclosed the negative impact the cyberattack had on operations, and none of the challenged statements were contradicted by the alleged loss of 10% of the subsidiary's high-margin business. Finally, the court concluded that the plaintiff failed to adequately plead scienter. The plaintiff's conclusory and speculative allegations that the defendant had access to contrary facts were insufficient to support a strong inference of scienter.

Reliance

SDNY Dismisses Claims Alleging Securities Fraud Violations Against Brazilian Electrical Company Based On Public Statements About Enforceability of Foreign Bearer Bonds

Eagle Equity Funds, LLC v. Centrais Eletricas Brasileiras S/A – Eletrobras, No. 19-CV-9344 (JMF) (S.D.N.Y. Feb. 3, 2021)
Click here to view the opinion.

Judge Jesse M. Furman dismissed with prejudice claims brought by certain investors against a Brazilian electrical company and two of its executives alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act concerning the company's statements on certain bearer bonds that were issued to the investors were unenforceable and that the company had no liability under the bearer bonds. The plaintiffs had acquired nearly 700 of those bearer bonds between 2008 and 2013 and had repeatedly tried but failed to enforce the bonds in Brazilian courts. The plaintiffs then acquired the company's American depositary receipts (ADRs) before filing the Securities Exchange Act suit.

The court dismissed the plaintiffs' claims based on their ownership of the ADRs because they failed to plead loss causation and reliance. The plaintiffs failed to allege a cognizable injury because a claim that the price of a security was merely "artificially inflated" did not prove that the plaintiffs had actually suffered harm from the inflation. The plaintiffs' theory that the company's misstatements deterred them from buying more ADRs also failed because it is "black-letter law that Plaintiffs cannot sue under Section 10(b) and Rule 10b-5 for having been deterred from purchasing additional securities." Finally, the court rejected the plaintiffs' claims that the company's statements damaged the value of the bearer bonds because the plaintiffs could not state a claim for fraud in connection with one security (*i.e.*, the ADRs) by alleging harms relating to another security (*i.e.*, the bearer bonds).

The court also found that the plaintiffs failed to plead reliance. The plaintiffs purchased the ADRs after they had spent six years challenging the company's position on the bearer bonds and thus purchased the ADRs despite their knowledge about the alleged misstatements.

Scienter

Ninth Circuit Affirms Dismissal of Securities Fraud Action Against Investment Bank Based on Analyst Report's Price Target for Failure To Plead Scienter

Prodanova v. H.C. Wainwright & Co., No. 19-56048 (9th Cir. Apr. 8, 2021)
Click here to view the opinion.

The court affirmed the dismissal of a putative securities fraud class action in a decision that provides additional guidance concerning the standard for pleading scienter.

H.C. Wainwright (HCW) is an investment bank. In October 2017, one of the bank's analysts published a report setting a $7 per share "buy target" for securities of MannKind Corporation, a publicly traded pharmaceutical company. Later that same day, a different division of the same bank announced that it was conducting an offering of MannKind securities at $6 per share.

The plaintiffs, purported MannKind shareholders, brought suit against HCW alleging that it violated Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 thereunder by making misleading statements designed to manipulate the market for MannKind securities. The district court dismissed the complaint for failure to plead scienter.

On appeal, the Ninth Circuit affirmed, holding that the complaint failed to plead scienter for four primary reasons. First, the complaint failed to allege a plausible motive to commit fraud. The plaintiffs alleged that the bank issued the $7 buy target report to generate interest in MannKind's securities and increase sales in the offering. The court rejected this theory as "divorced from common experience," reasoning that the plaintiffs had not shown that the bank would gain more compensation from an offering that sold more shares, and that the bank had more to lose from potentially straining its relationship with MannKind than it stood to gain from potentially increased compensation.

Second, the plaintiffs failed to plead that anyone at the bank — the price target report's author, the bank's CEO or the bank's compliance division — knew that that price target report conflicted with the MannKind offering price. The plaintiffs pointed to a confidential witness declaration that the bank generally adhered to industry standards for checking conflicts of interest in an effort to show that the bank's conflicts procedures would have caught the conflict between the analyst report and the offering, and therefore the former must have been issued in a deliberate attempt to deceive the market. The court rejected these allegations, however, because they did not suggest that any individual defendant knew that the upcoming price target report and offering price conflicted with one another, and because the confidential witness left the company before the events at issue.

Third, the plaintiffs failed to plead scienter under the core operations doctrine because they did not allege facts showing that either (i) the bank's senior management was versed in the minutia of upcoming analyst reports or (ii) the conflict between the analyst report's target price and the MannKind offering price was of such prominence that it would be "absurd" to suggest that management did not know about it. Without such facts, the court held that it could not impute knowledge of the conflict between the analyst report and the offering price to the bank's senior management.

Fourth, there was no inference of scienter based on the bank's alleged failure to issue a statement correcting the price target report. The plaintiffs argued that the court could infer scienter from the bank's failure to issue a correction to the price target after it disclosed the lower offering price. The court rejected this argument, refusing to recognize any duty to correct under the federal securities laws. The court also held that while a failure to correct an allegedly misleading statement can enhance an inference of scienter into the "strong inference" required by the PSLRA, it cannot establish an inference of scienter by itself. Because the plaintiffs failed to plead facts raising an inference of scienter in the first place, their duty to correct argument failed.

Northern District of Illinois Dismisses Putative Securities Class Action, Declining To Find That CFPB Investigation Led to Inference of Scienter

Heavy & Gen. Laborers' Loc. 472 & 172 Pension & Annuity Funds v. Fifth Third Bancorp, No. 20 C 2176 (N.D. Ill. Apr. 26, 2021)
Click here to view the opinion.

Judge Sara L. Ellis granted a motion to dismiss a putative class action against Fifth Third Bancorp, its chairman and CEO, Gregory Carmichael, and its former CFO, Tayfun Tuzun, without prejudice. A September 2020 consolidated complaint filed by the lead plaintiff alleged that Fifth Third and its officers engaged in federal securities fraud by concealing certain purported unethical sales strategies and failing to disclose that the Consumer Financial Protection Bureau (CFPB) had initiated an investigation into its sales practices in November 2016. The complaint alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act, subjecting it to the heightened pleading standards of the PSLRA and Rule 9(b).

In November 2016, the CFPB notified Fifth Third of an investigation into its sales practices, in particular regarding the possible opening and use of unauthorized consumer accounts. In March 2020, the CFPB filed a complaint against Fifth Third, alleging that Fifth Third improperly used cross-sell strategies and incentive-based compensation resulting in the opening of unauthorized accounts in violation of the Truth in Lending Act and the Truth in Savings Act.

Based on the allegations in the CFPB complaint, multiple plaintiffs brought putative class actions alleging that during the class period — from November 2016 to March 2020 — defendants Fifth Third, Mr. Carmichael and Mr. Tuzun made false and misleading statements and material omissions regarding Fifth Third's (i) purported risk disclosures, (ii) risk management practices, (iii) Code of Business Conduct and Ethics, (iv) product cross-selling and consumer business, and (v) employee incentive compensation. The court consolidated the actions and appointed a lead plaintiff.

Fifth Third moved to dismiss the lead plaintiff's consolidated complaint, and the court granted Fifth Third's motion and dismissed the claims against all the defendants. The court held that the plaintiff failed to allege facts that give rise to a strong inference of scienter on the part of any defendant. In particular, the court declined to find that the CFPB's investigation led to an inference of scienter, holding that finding otherwise would improperly infer fraud by hindsight. The court also held that knowledge of an investigation into alleged illegal practices does not equate to knowledge of those practices themselves; thus, the defendants' knowledge of the CFPB investigation did not indicate that they knew of the purported opening of unauthorized accounts. Additionally, the court held that scienter cannot be inferred merely from an executive's position or incentive-based compensation. Having found that the plaintiff's failure to give rise to a strong inference of scienter was dispositive, the court made no additional findings and dismissed the case without prejudice.

SDNY Grants Motion To Dismiss Claims Brought by Putative Class of Investors in Connection With Company's IPO

Lau v. Opera Ltd., No. 20-cv-674 (JGK) (S.D.N.Y. Mar. 13, 2021)
Click here to view the opinion.

Judge John G. Koeltl granted a motion to dismiss claims brought by a putative class of investors against a software company, its individual directors and the financial institutions that underwrote the company's IPO completed on August 9, 2018, and its secondary public offering (SPO) completed on September 20, 2019. The plaintiffs brought claims for violations of Sections 10(b) and 20(a) of the Securities Exchange Act and Sections 11 and 15 of the Securities Act alleging that the company made certain misstatements and omissions concerning its declining market share with respect to web browser services and its risky entry into the fintech market.

The court dismissed the plaintiffs' claims, holding that they failed to plead a material misstatement or omission. The court rejected the plaintiffs' contention that because the company's prospectuses released before its IPO and SPO had identified the company as a "market leader," the defendants had a duty under Item 303 of Regulation S-K to disclose the company's decline in market share. The court determined that those statements about the company's growth were nonactionable corporate puffery. The court also noted that the statements at issue concerned market share of mobile users only and not market share for the total user base, and therefore found that the plaintiffs' argument was meritless because although the company's share of the total browser market had declined, the company's revenue and net income had increased during the relevant time period. The court additionally found that the defendants' statements about the company's market share could not be material because the company directed investors to market share information that was publicly disclosed and available online from an independent web analytics company.

The court also rejected the plaintiffs' contention that the company's offering documents in connection with the IPO violated Items 101 and 105 of Regulation S-K by failing to disclose the company's entry into the fintech market. The court determined that although the company held a minority interest in a certain entrant into the fintech market, no disclosure obligations were triggered because neither the company itself nor any of its subsidiaries entered into the fintech market. Similarly, the court found that the company could not have disclosed the risks associated with the fintech business before its IPO as required by Item 105 because the circumstances giving rise to those risks (*i.e.*, the purchase of a fintech company) did not happen until after, at which point the company disclosed its entry into the fintech market.

The court also determined that the plaintiffs failed to adequately plead scienter. Because the defendants had specifically referred investors to public information about its market share, the court found that the plaintiffs could not adequately allege that the defendants had access to facts contrary to what they stated.

EDNY Dismisses Complaint Against Global Biopharmaceutical Company Alleging Material Misrepresentations Regarding Approvability of Its Depression Drug

In Re Alkermes Pub. Ltd. Co. Sec. Litig., No. 18-CV-7410 (LDH) (RML) (E.D.N.Y. Feb. 26, 2021)
Click here to view the opinion.

Judge LaShann DeArcy Hall dismissed claims brought by a putative class of investors against a global biopharmaceutical company and certain of its officers, alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act by downplaying FDA concerns regarding the approvability of the company's drug intended to treat a depressive disorder.

The court held that the plaintiffs did not adequately allege a strong inference of scienter. Allegations about the individual defendants' roles at the company and that the drug was a "blockbuster" in which the company "invested significant resources" did not support an inference that the individual defendants knew or recklessly disregarded the FDA concerns conveyed to the company regarding the drug. The court reasoned that the plaintiffs "overstated the import of the information" conveyed by the FDA to the company and relied on a "blatant mischaracterization" of certain FDA documents. For example, the FDA briefing document did not reveal any information that "should reasonably have been interpreted to suggest that FDA approval of [the drug] was not possible or even unlikely." The court further determined that, although the FDA expressed concerns regarding the company's trial methodology for the drug and ultimately denied the new drug application, the FDA still allowed the drug to progress through the further stages of the application process. The court concluded that the nature of the concerns conveyed by the FDA failed to support an inference that the "Defendants did not honestly believe that their statements of optimism" given to the investors were true when made.

Eastern District of Tennessee Dismisses Securities Class Action With Prejudice

City of Taylor Gen. Emps. Ret. Sys. v. Astec Indus., No. 1:19-cv-24 (E.D. Tenn. Feb. 19, 2021)
Click here to view the opinion.

Judge Charles E. Atchley Jr. granted a motion to dismiss with prejudice a putative securities class action against Astec Industries and its executives. The allegations arose from Astec's operation of wood pellet manufacturing plants. According to the plaintiffs, Astec executives made false or misleading statements about the profitability of these plants, artificially inflating Astec's stock price. The plaintiffs' claim is based on the Securities Exchange Act and subject to the heightened pleading standards of the PSLRA.

In the early 2010s, Astec entered the wood pellet industry. It financed the purchase of an existing plant in Hazlehurst, Georgia for $60 million, with the idea of selling wood pellets to countries in the European Union. However, the Hazlehurst plant was powered by burners that ran on natural gas, not wood pellets, meaning the pellets would not meet the environmental standards to be sold in the EU. Astec changed its burners, but its CEO assured Astec's investors "there is no risk" to the project. However, the plant continued to run on natural gas when running tests and Astec was forced to extend the due date on its loan. Astec ultimately wrote the plant off as a loss and sold it for $20 million in July 2019.

In 2015, Astec entered a contract to build another plant, the Highland plant. As part of this contract, Astec had to demonstrate the plant was reliable and could meet EU standards. However, like the Hazlehurst plant, the Highland plant used burners that ran on natural gas. Still, Astec's CEO assured investors that the plant would prove to be reliable. In late 2018, independent auditors assessed the Highland plant, identifying several problems, including with hammer mills. However, earlier in 2018 Astec's CEO had told investors that Astec had fixed the hammer mills, albeit with some ongoing problems.

In May 2018 Astec's CEO sold 60,000 shares of Astec stock, making $3.2 million from the sale. On July 24, 2018, Astec issued a press release revealing that its wood pellet business was struggling and that it was exiting the Highland plant contract. Astec shareholders filed a class action alleging the company and its officers made material misstatements in violation of Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 thereunder. The defendants moved to dismiss, arguing that the allegations in the complaint failed to raise a strong inference of scienter.

The court granted the motion to dismiss because the plaintiffs failed to allege facts that would justify a strong inference of scienter. To show scienter, the plaintiffs primarily alleged that Astec's CEO engaged in a suspicious incident of insider trading. Based on the time and size of the transaction, the court agreed that it could provide evidence of scienter. However, the court found that none of the plaintiffs' other allegations supported scienter. The court held that the single trade alone was not enough to make scienter as likely as an innocent explanation for the statements at issue.

SLUSA

Ninth Circuit Reverses Dismissal of Fiduciary Duty Suit, Holds That SLUSA's State Law Class Action Bar Does Not Apply to Claims Brought Against Investment Brokerage

Anderson v. Edward Jones & Co., No. 19-17520
(9th Cir. Mar. 4, 2021)
Click here to view the opinion.

The Ninth Circuit reversed the dismissal of a putative class action alleging claims for breach of fiduciary duty under California and Missouri law, holding that the plaintiffs' claims were not subject to the Securities Litigation Uniform Standards Act of 1998's (SLUSA) state law class action bar.

Edward Jones is an investment brokerage. The plaintiffs were a group of purported Edward Jones investors who allegedly switched their investment accounts from a commission-based model to a fee-based model at Edward Jones' invitation. The plaintiffs brought a class action alleging that Edward Jones failed to conduct a suitability analysis purportedly required by Financial Industry Regulatory Authority rules before recommending the switch. The plaintiffs alleged claims for securities fraud under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 thereunder, and breach of fiduciary duty under California and Missouri common law.

The district court dismissed both claims. The district court first dismissed the securities fraud claim for failure to plead an actionable omission, and the plaintiffs elected not to appeal that decision. The district court then dismissed the plaintiffs' fiduciary duty claims for lack of subject matter jurisdiction, holding that the claims were barred by SLUSA, which prohibits the plaintiffs from bringing most state law class actions alleging a misrepresentation or omission in connection with the purchase or sale of a security. The court concluded that the plaintiffs were alleging a misrepresentation or omission (failing to conduct a suitability analysis) in connection with securities transactions (Edward Jones' investment activities on behalf of the plaintiffs), and therefore the SLUSA class action bar prohibited the plaintiffs' claims.

On appeal, the Ninth Circuit reversed. The court first rejected Edward Jones' argument that all state law claims based on the same theory as a securities fraud claim pled in the same complaint are necessarily barred by SLUSA. The court held that state law claims must be analyzed independently on a case-by-case basis to determine whether they are alleging a misrepresentation or omission in connection with a securities transaction.

The court next examined the U.S. Supreme Court's decisions in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006), and *Chadbourne & Park LLP v. Troice*, 571 U.S. 377 (2014), and held that state law class actions are only barred by SLUSA when the alleged misrepresentations and omissions at issue are material "to someone's decision to purchase or to sell a covered security." Applying that analysis, the court concluded that the plaintiffs' fiduciary duty claims did not allege a misrepresentation or omission in connection with the purchase or sale of a security because Edward Jones' purported omission — its alleged failure to conduct a suitability analysis before recommending that customers switch from a commission-based to a fee-based investment model — was not material to the plaintiffs' decision to purchase or sell any particular securities. The court remanded the plaintiffs' fiduciary duty claims to the district court for further proceedings.

Statutes of Repose

SDNY Dismisses Securities Act Claims Against Express Delivery Company

Nurlybayev v. ZTO Express (Cayman) Inc., No. 17 CV 6130-LTS-SN (S.D.N.Y. Mar. 31, 2021)
Click here to view the opinion.

Judge Laura Taylor Swain denied a motion to amend a complaint brought by a putative class of investors against a Chinese express delivery company alleging violations of Sections 11, 12(a)(2) and 15 of the Securities Act. The plaintiffs alleged that the registration statement and prospectus filed in connection with the company's IPO omitted material information about a recent change in the company's pricing. The plaintiffs alleged that the company reduced its network transit fees in April 2016 but failed to disclose that reduction until an earnings call in May 2017. The court had previously dismissed these allegations for failure to state a claim. In their proposed amended complaint, the plaintiffs sought to add entirely new allegations that the company made "off-the-books share-based payments" to one of its trucking vendors that "depart[ed] from the standard practice of making cash-based payments" and intentionally presented "more robust earnings and margins than would have been presented to investors using standard accounting."

The court determined that the plaintiffs' new allegations concerning the off-the-books payments failed to cure the deficiencies identified by the prior opinion dismissing their complaint. The court held that these claims, alleged "for the first time" in the plaintiffs' proposed amended complaint, were barred by the applicable one-year statute of limitations because they "do not arise from the same conduct, transaction, or occurrence as their prior claims, and [thus] do not relate back under Federal Rule of Civil Procedure 15(c)(2)." The court also noted that even if these new allegations were timely, they "would fail to state a claim upon which relief may be granted, principally because they are premised on a misreading of [the company's] Offering Documents," which in fact disclosed the allegedly omitted share-based compensation.

District of Connecticut Dismisses Certain Securities Exchange Act Claims Against Pharmaceutical Company, Declines To Dismiss Claims Under Israeli Law

In re Teva Sec. Litig., No. 3:20-cv-588 (SRU) (D. Conn. Jan. 22, 2021)
Click here to view the opinion.

Judge Stefan R. Underhill dismissed with prejudice certain claims brought under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 thereunder against a pharmaceutical company because they fell outside the statute of repose, but he declined to dismiss claims that arose under Israeli securities law. The plaintiffs alleged that the company misled investors by claiming that its success arose from good management and good businesses decisions but concealing that the company colluded with competitors to inflate the prices of generic drugs that the company manufactured.

The defendants moved to dismiss the Securities Exchange Act claims arising from each alleged misstatement or omission made outside of the applicable five-year statute of repose, arguing that the clock began to run for each statement on the day that it was made. The court determined that the applicable five-year statute of repose began to run for each statement on the day it was made and rejected the plaintiffs' argument that the clock began to run only after the last alleged misstatement. The court found that the statutory language clearly indicated legislative intent to cut off liability after five years for each alleged misstatement. The court also rejected the plaintiffs' argument that their alleged "scheme liability" allegations tied all the alleged misstatements and omissions together as part of a single scheme rendering the statute of repose irrelevant. The court found that the complaint was governed by SEC Rule 10b-5(b) and reasoned that the plaintiffs were improperly attempting "to re-fashion their Rule 10b-5 claim into a 'scheme liability' claim for purposes of the relevant statute of repose."

The court also found that it had supplemental jurisdiction over the Israeli law claims because they were "in every important respect, identical" to the U.S. securities law claims. The claims also did not raise a novel or complex issue compelling the court to decline supplemental jurisdiction because "it is settled as a matter of Israeli law that United States securities law establishes civil liability" under Israeli securities laws, and there were no specific thorny or practical issues the court would face in adjudicating the Israeli law claims. The court also declined to dismiss the Israeli law claims under the doctrine of *forum non conveniens* because it was economical and convenient to deal with the claims in one proceeding, since the "lion's share of evidence and witnesses are in the United States" and the Israeli law claims were secondary to the United States claims.

Inside the Courts
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